OCT 16 1998

BEFORE THE

Federal Communications Commission

WASHINGTON, D.C.

In the Matter of The Deployment of Wireline Services Offering Advanced Telecommunications Capability	)))))))	CC Docket No. 98-147

REPLY COMMENTS OF TIME WARNER TELECOM

WILLKIE FARR & GALLAGHER
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000

ATTORNEYS FOR TIME WARNER TELECOM

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Time Warner Communications Holdings Inc. d/b/a Time Warner Telecom ("TWTC"), by its attorneys, hereby files its reply comments in response to the Notice of Proposed Rulemaking in the above-captioned proceeding.[1]

I. INTRODUCTION AND SUMMARY

As the comments in this proceeding demonstrate, the FCC's proposal to allow ILECs to provide advanced services through unregulated affiliates ("Section 706 affiliates") enjoys little support. The Comments from CLECs demonstrate that the proposal will likely harm, rather than benefit, competition in the provision of advanced services. This is because the proposal will not prevent ILEC anticompetitive behavior and will make the consequences of such behavior worse than would be the case if ILEC advanced services were subject to incumbent LEC regulation

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1 See Deployment of Wireline Services Offering Advanced Telecommunications Capability, CC Docket No. 98-147, *Memorandum Opinion and Order, and Notice of Proposed Rulemaking* (rel. Aug. 7, 1998) ("Notice").

under Section 251(c). The ILECs, however, blithely ignore this problem and simply state that the FCC has not gone far enough to deregulate their provision of advanced services. They hardly even attempt to demonstrate that the provision of advanced services on a deregulated basis would not harm advanced services competition.

It is therefore clear that the FCC must abandon its Section 706 proposal. It must instead subject ILEC advanced services to the unbundling and resale requirements of Section 251(c). The FCC must *not* accept the ILECs' claim that *less* regulation of their advanced services is needed. Those requests, if implemented, would only make it more likely that ILECs would leverage their local monopolies to harm competition in the provision of advanced services.

II. THERE IS NO BASIS IN THE RECORD FOR ADOPTING THE COMMISSION'S SECTION 706 AFFILIATE PROPOSAL.

As TWTC demonstrated in its initial comments in this proceeding, the Commission's proposal to allow ILECs to provide advanced services through an unregulated separate subsidiary will harm the development of competition in the provision of advanced services. For example, notwithstanding the structural separation proposed in the Notice, ILECs will have the opportunity to discriminate in favor of their unregulated affiliates. Moreover, because their 706 affiliates would be unregulated, the *consequences* of discrimination will be much worse than if the affiliate were subject to ILEC regulation. This is because discrimination will allow the ILEC to establish its affiliate's advanced services as the only viable advanced service offering in certain areas (e.g., wire centers or clusters of wire centers).

In addition, deregulating the advanced services of the ILEC would give the ILEC the incentive to cross-subsidize those services. This incentive would not exist in the same way if the ILEC's advanced services were subject to the same rate regulation as other ILEC services.

Finally, the proposed 706 affiliate would give the ILEC the incentive and opportunity to move essential facilities to the unregulated affiliate. Such facilities would of course not be available to competitors on an unbundled basis, thus harming competition. To try to prevent this result, the FCC and possibly state commissions must engage in imperfect and intrusive monitoring.

Nothing in the comments in this proceeding either diminishes the strength of these arguments or in any way provides a basis for supporting the 706 affiliate proposal. Of course, it follows that nothing in the record supports ILEC requests that they be subject to less onerous structural separation than is proposed in the Notice.

A. Requiring Outside Ownership Of A 706 Affiliate, While Helpful, Would Not Eliminate The ILECS' Incentive And Opportunity To Engage In Anticompetitive Behavior.

Several of the competitive LECs and IXCs argued in their comments that ILECs are less likely to harm competition for the provision of advanced services if they must share ownership of the Section 706 affiliate with outsiders.[2] While the parties that support this proposal oppose the adoption of the Section 706 affiliate proposal, they offer the outside ownership suggestion as a way of diminishing the harm of the 706 affiliate if it is nevertheless adopted. Based on the virtually uniform opposition to the 706 affiliate proposal among incumbents, it seems unlikely that any ILEC would be willing to provide advanced service through an affiliate partially owned by outsiders. In any case, as Dr. Leland Johnson explains in a declaration attached to these reply comments,[3] outside ownership would reduce but not eliminate the potential for anticompetitive behavior.

Dr. Johnson explains that outside ownership of the Section 706 affiliate will force the ILEC to share some of the benefits its anticompetitive behavior bestows on the affiliate.[4] As the cost to the ILEC of anticompetitive behavior and the percentage of outside ownership (i.e., the percentage of sharing required) increase, the ILEC's incentive to unfairly favor its affiliate decreases.[5] This is true regardless of whether the anticompetitive behavior takes the form of cross-subsidization or discriminatory access to essential facilities. Dr. Johnson states, however, that "if arrangements could be made for outside owners to share the costs of the subsidy [or discrimination] with

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2 See Comments of CompTel at 22, Comments of AT&T at 21.

3 See Appendix ("Johnson Reply Dec.").

4 See id. at 4.

5 See id. at 4-5.

the ILEC in proportion to their share of gains, both could benefit."[6] In other words, such tacit cooperation between the ILEC and the outside owners would lower the cost to the ILEC of the anticompetitive behavior thus making such behavior more likely.

In addition, Dr. Johnson concludes that outside ownership in the affiliate would diminish the incentive for ILECs to offer essential facilities on an overpriced, though nondiscriminatory, basis.[7] If outside owners hold high-level positions within the affiliate, they are especially likely to prevent the ILEC from overcharging the affiliate. However, as Dr. Johnson observes, in this instance tacit cooperation could again reduce the wholesome influence of outside owners. For example, the ILEC might use an appropriate proportion of the profits gained from overcharging the 706 affiliate to benefit the 706 affiliate (either through discrimination or cross-subsidy). The outside owners' proportion of the cost of overpriced essential facilities would therefore be paid for through preferential treatment from the ILEC. Finally, as Dr. Johnson explains, this strategy could be executed without the outside owners having any knowledge of the anticompetitive behavior.[8] Indeed, ironically, it may be easier to achieve such

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6 See id. at 5.

7 See id. at 6-7.

8 See id. at 8.

tacit cooperation where the outside owners are represented in high-level positions within the affiliate.[9]

B. ILEC Arguments In Favor of More Limited Structural Separation or No Separation At All Must Be Rejected.

All of the ILECs urge the Commission to allow them to provide advanced services on an unregulated basis and subject to no structural separation or to more limited structural separation than was proposed in the Notice.[10] All of these proposals will only increase the ILECs' opportunity to leverage their local monopolies to harm competition. The anticompetitive activities that the ILECs would engage in if subject to the proposed 706 affiliate as proposed in the Notice would therefore be even more likely under the ILEC proposals. They must therefore be rejected out of hand.[11]

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[9] See id.

[10] Some of the ILECs have gone so far as to assert that imposing resale obligations on advanced services eliminates ILEC incentives to provide those services. This argument is not believable because the wholesale discount only marks down the service price (which may reflect short depreciation lives and high risk capital) to the extent the ILEC saves costs by selling at wholesale rather than at retail. There is little or no risk therefore that the resale obligation would prevent ILECs from recovering the full costs of providing advanced services.

[11] Thus, the FCC need not waste time considering the proposal that it adopt the *Competitive Carrier* separate subsidiary model in this proceeding. See Comments of BellSouth at 39-41; Comments of GTE at 13-20. Cf. Comments of SBC at 5-12. But in no case can the *Competitive Carrier* model apply to BOCs. In establishing Section 272 protections, Congress specifically rejected the *Competitive Carrier* model for BOCs in the interLATA context as insufficient. The BOCs have just as many opportunities to discriminate in favor of and cross-subsidize its advanced services as interLATA services. Moreover, most advanced services will eventually be

Ameritech is apparently the only ILEC that is willing even to consider providing advanced services through an affiliate that resembles the FCC's proposed Section 706 affiliate. Indeed, it is TWTC's understanding that Ameritech is already planning to provide or is actually providing advanced services through an affiliate that it treats as "unregulated." But even Ameritech urges the FCC to adopt a change that would make the already flawed 706 affiliate proposal even more dangerous.

Specifically, Ameritech argues that ILECs should be permitted to "perform operations, installation, and maintenance on equipment and facilities owned by their data affiliates."[12] But in the Non-Accounting Safeguards proceeding, the FCC held that

> allowing the same individuals to perform such core functions [as operations, installation and maintenance] on the facilities of both [the ILEC and its affiliate] would create substantial opportunities for improper cost allocation, in terms of both the personnel time spent in performing such functions and the equipment utilized. . . . allowing the sharing of such services would require "excessive, costly and burdensome regulatory involvement in the operation, plans and day-to-day activities of the carrier . . ."[13]

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interLATA in nature. Thus, while Section 272 safeguards are themselves insufficient for any ILEC, the more lenient *Competitive Carrier* separation requirements would cause even greater harm and cannot be applied to BOCs.

12 See Comments of Ameritech at 55.

13 Implementation of the Non-Accounting Safeguards of Sections 271 and 272, *First Report and Order*, 11 FCC Rcd 21905, ¶ 163 (1996) ("Non-Accounting Safeguards Order").

In addition, such integration would allow ILEC employees to learn about the business plans of the affiliate in detail, including the specific technological needs of the affiliate. The ILEC could then easily design its regulated facilities to subtly but importantly discriminate in favor of the ILEC affiliate. Such discrimination would be extremely difficult to detect.[14]

Ameritech argues that, since the ILEC can perform the services in question on CLEC facilities, it is only fair to allow the ILEC to perform these functions on the ILEC affiliate's facilities.[15] This is simply a red herring. The fact is that there is a substantial danger of cross-subsidy and discrimination where the ILEC performs operations, installation, and maintenance on affiliate equipment.

Nor is it any answer to assert, as Ameritech does, that existing regulations protect against ILEC cross-subsidy and discrimination in this context. The Commission itself determined in the Non-Accounting Safeguards Order that its existing rules could not provide enough protection against cross-subsidy if the ILEC performs operations, installation and maintenance on an affiliate's equipment and facilities. Moreover, as Dr. Johnson demonstrated in the affidavit submitted with TWTC's initial comments, regulators are unlikely to be able to prevent discrimination even where the ILEC is not permitted to perform

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14 See Johnson Aff. (Appendix A of TWTC Comments) at 8-10.

15 Comments of Ameritech at 56.

operations, installation, and maintenance on affiliate equipment.[16]

C. The Comments Confirm The Level Of Complexity Involved In Determining Which Equipment Can Be Owned By An Affiliate

As mentioned, under the 706 unregulated affiliate proposal, regulators would be required to ensure that ILECs continue to offer on an unbundled basis those facilities that are essential to the provision of advanced services. This would require the regulators to monitor closely facilities that the affiliate owns. Of course, if a 706 affiliate does end up with exclusive control over an essential facility, competition will be seriously harmed because competitors will not be able to obtain that facility on an unbundled basis from the unregulated affiliate.

The comments in this proceeding confirm that the process of distinguishing essential from non-essential facilities would be extremely difficult. This is because different competitive providers need different equipment in order to compete. The comments regarding unbundled loops illustrate the point. Thus, while at least one CLEC believes that ILECs must provide loops equipped with electronics on an unbundled basis,[17] another states that ILECs must allow competitors access to "raw" copper loops for its CDM technology.[18] Still other competitors need

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16 See Johnson Aff. at 6-10.

17 See Comments of e.spire at 40-41.

18 See Comments of Transwire at 37-38.

"conditioned" copper for the purpose of providing ADSL service.[19] This diversity makes it difficult indeed to establish a comprehensive list of unbundled elements. No doubt the list becomes even more complex when the needs of non-wireline competitors are accounted for.

In addition, the necessary inputs for a particular competitor will change overtime as the competitor uses new, more efficient technology. Indeed, equipment that is not essential to any competitor now, may become so in the future. Yet, again, if the 706 affiliate has exclusive control over the facilities that become essential in the future, competitors will not be able to obtain them on an unbundled basis.

III. THERE IS NO MERIT IN ILEC ARGUMENTS THAT THE FCC CANNOT IMPOSE ILEC REGULATION ON AN ADVANCED SERVICES AFFILIATE THAT DOES NOT COMPLY WITH THE SAFEGUARDS PROPOSED IN THE NOTICE.

There are strong policy and legal reasons why the FCC must consider even the 706 affiliate as proposed to be an incumbent LEC under Section 251(h). However, several ILECs have now argued that the FCC lacks the authority to impose ILEC regulation on an ILEC affiliate that is subject to even more limited structural separations requirements than those proposed in the Notice. Ameritech presents this argument in the most detailed and developed form. As Ameritech's version demonstrates, the argument is completely meritless.

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[19] See Comments of Northpoint at 17; Comments of Intermedia at 55.

Ameritech asserts that an ILEC advanced services affiliate would not necessarily fall within the definition of an incumbent LEC in Section 251(h). First, Ameritech asserts that an ILEC affiliate that began providing service after enactment of the 1996 Act cannot be deemed to be an incumbent LEC under Section 251(h)(1).[20] Second, Ameritech asserts that an ILEC affiliate that did begin providing service after February 6, 1996 can only be classified as an incumbent if it (1) is declared to be "comparable" to an ILEC, (2) holds a dominant position in the market, and (3) has "replaced" the ILEC."[21]

Taken to its logical extreme, Ameritech's position is that an ILEC could create a separate affiliate after passage of the 1996 Act and transfer whatever facilities it chose to that affiliate without any risk of the affiliate being treated as an ILEC *until* the affiliate actually replaces the ILEC as the dominant provider of service. Up until that time, the artifice of a separate subsidiary (apparently regardless of the extent of separation) would shelter the affiliate from the application of Section 251(c).

This argument is easily rejected for two fundamental reasons. First, it is well established that a regulatory agency may disregard separate affiliate structures where they have been created for the sole purpose of frustrating federal policy. For

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[20] See Comments of Ameritech at 50.

[21] See Comments of Ameritech at 53.

example, in General Telephone Co. v. FCC,[22] the Fifth Circuit held that the FCC properly applied Section 214 -- applicable only to common carriers -- to carriers' non-carrier cable affiliates. The Commission did so to prevent the telephone companies from favoring their non-carrier affiliates over competitors. In affirming the Commission, the court explained its reasoning as follows:

> [T]he activities of the non-common carrier affiliates may be imputed to the common carrier parent. To hold otherwise would balk the Commission in the execution of its statutory duties. The anticompetitive practices, real and potential, which the Commission sought to eradicate through its rules are effected through the instrumentality of an affiliate . . . company. Where the statutory purpose could thus be easily frustrated through the use of separate corporate entities, the Commission is entitled to look through corporate form and treat the separate entities as one and the same for purposes of regulation.[23]

The FCC therefore has the authority to "look through corporate form" and attribute to the ILEC the actions of its subsidiary where appropriate. It would certainly be appropriate to do so where, as in Ameritech's scheme, an ILEC could avoid application of Section 251(c) simply by establishing a separate subsidiary that commences providing service after enactment of the Act.

Second, the FCC need not even rely on Section 251(h) to impose unbundling and resale obligations on an ILEC advanced services affiliate. Virtually all advanced data services will be

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22 449 F.2d 846, 855 (5th Cir. 1971).

23 Id. See also Transcontinental Gas Pipe Line Corp. v. FERC, 998 F.2d 1313, 1320 (5th Cir. 1993) (FERC properly forbade a gas company from using subsidiaries to sell excess gas at prices which the regulated company could not legally offer).

interstate in nature. Pursuant to its authority to ensure just and reasonable charges and practices under Section 201(b), the FCC could impose any reasonable restrictions it chose on ILEC provision of such services (either through an affiliate or on an integrated basis). Ameritech's detailed parsing of the definition of the terms of Section 251(h) is therefore beside the point.

IV. THE COMMISSION SHOULD REJECT ARGUMENTS AGAINST REQUIRING COLLOCATION OF INTEGRATED EQUIPMENT AS WELL AS OVERSTATED SECURITY CONCERNS.

The ILECs attack the FCC's collocation proposals as either unlawful, unwise or unnecessary. Most of these arguments are obviously meritless. There is no question that national rules for collocation are necessary since, without them, the ILECs will continue to abuse their superior bargaining power in negotiations with CLECs to raise the cost and reduce the efficiency of collocation arrangements.

The ILECs make two arguments which deserve special attention. First, several ILECs have argued that, since switching equipment is not "necessary" for interconnection or the combination of unbundled elements, the FCC lacks the authority to require ILECs to allow physical collocation of such equipment.[24] The argument is that, under the "strict test of statutory authority" established in Bell Atlantic Tel. Cos. v. FCC,[25] the

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[24] See Comments of SBC at 16; Comments of U S WEST at 36-38; Comments of Ameritech at 39-40.

[25] 24 F.3d 1441 (D.C. Cir. 1994).

Section 251(c)(6) requirement that ILECs provide "physical collocation of equipment necessary for interconnection or access to unbundled network elements" cannot be read to permit collocation of switching equipment.[26] This argument is easily dismissed.

As the FCC suggests in the Notice, the most important context in which switching equipment should be made eligible for physical collocation is where switching and multplexing functions are performed by the same piece of equipment. As the FCC states, a current trend in manufacturing is to integrate multiplexing and switching functions.[27] Vendors increasingly offer a single piece of equipment that performs both functions. It is in this context that the FCC should require physical collocation.

In the Local Competition Order, the FCC held that Section 251(c)(6) requires ILECs to provide collocation of optical terminating equipment and multiplexers on ILEC premises as necessary for interconnection and connecting UNEs.[28] The Eighth Circuit specifically upheld this decision.[29] Under existing law, therefore, a competitor may collocate equipment that performs optical termination or multiplexing functions. The rule is no

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[26] See U S WEST Comments at 37.

[27] Notice at ¶ 128.

[28] See Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, 11 FCC Rcd 15499, ¶ 580 (1996).

[29] See Iowa Utils. Bd. v. FCC, 120 F.3d 753, 818 (8th Cir. 1997).

different if that equipment also happens to perform switching functions. But to prevent the inevitable ILEC attempts to contest the issue, the FCC can and should clarify that ILECs are required under Section 251(c)(6) to allow physical collocation of such integrated equipment.[30]

Second, almost all of the ILECs claim that the different forms of "cageless" collocation discussed in the Notice should be rejected outright because of the alleged security issues they raise. These concerns are overstated and should not cause the FCC to abandon its sound tentative conclusions that cageless collocation should be required. Instead, the FCC should require ILECs to offer cageless collocation and should refer any security concerns it deems appropriate for resolution by state commissions, which are better placed to handle them.

V. THE FCC SHOULD PROVIDE INTERLATA RELIEF ONLY IN VERY LIMITED CIRCUMSTANCES

A BOC may not provide interLATA services if it meets the requirements of Section 271. Until a BOC complies with these requirements, Section 271 only permits the provision of "incidental interLATA" services, defined in Section 271(g). Congress specifically stated that the definitions of these

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[30] Bell Atlantic's argument that physical collocation should be permitted only for equipment used "exclusively" for interconnection or access to unbundled elements is absurd. See Bell Atlantic Comments at 37. There is no support for this restriction either in the FCC's Local Competitive Order or the Iowa Utils Bd. decision. Moreover, if adopted, this approach would essentially prohibit CLECs from collocating efficient equipment. This cannot be the result Congress intended.

incidental services must be "narrowly construed."[31] Thus, Congress provided the Commission with specific guidance as to the instances in which interLATA services may be provided. Further, as the FCC has determined in this proceeding, the Commission does not have the authority to forbear from enforcing Section 271.[32]

In the Notice, the FCC proposed two forms of interLATA relief. First, the FCC asked whether the definition of incidental service in Section 271(g)(2) (permitting "two-way interactive video services or Internet services over dedicated facilities to or for elementary and secondary schools as defined in section 254(h)(5)") would allow it to permit BOCs to serve school districts that cross LATA boundaries. While the statute would appear to permit this form of relief, it may be granted only in limited circumstances.

Specifically, the FCC must construe Section 271(g)(2) "narrowly" by ensuring that only those primary and secondary schools that fall within the definition of Section 254(h)(5) receive service. Furthermore, the Commission is required to ensure that the provision of "incidental" interLATA services by a BOC or BOC affiliate "will not adversely affect telephone exchange service ratepayers or competition in any

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31 See 47 U.S.C. § 271(h) ("The provisions of subsection (g) are intended to be narrowly construed").

32 See Deployment of Wireline Services Offering Advanced Telecommunications Capability, *Memorandum Opinion and Order*, CC Docket No. 98-147, ¶¶ 69-77 (Aug. 7, 1998).

telecommunications market."[33] There is already a competitive market for providing high speed Internet access and video services to the elementary and secondary schools defined in Section 254(h)(5).[34] BOCs would have the incentive and opportunity leverage their local monopolies to harm competition in the provision of those services. Thus, a BOC must not be permitted to provide interLATA Internet and video services to schools unless it demonstrates that those schools cannot and will not receive those services from any other source.[35]

The second form of interLATA relief suggested on the Notice is potentially more dangerous. The FCC proposed to rely on its authority to modify LATA boundaries[36] to encourage the provision of high-speed data service to rural areas and more generally to encourage the deployment of high-speed services. But, considered in context, the reference to "modified" LATA boundaries in Section 153(25) empowers the FCC to make only the most limited adjustments in LATA boundaries.

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33 See 47 U.S.C. § 271(h).

34 The FCC subsidy regime for schools and libraries made the provision of these services even more competitive

35 Even if the alternative is more expensive that the BOC interLATA service, the BOC must not be permitted interLATA relief. If a school cannot afford the price in question, the available subsidies under the schools/libraries program should eliminate this problem.

36 See 47 U.S.C. § 153(25) (defining LATA as "a contiguous geographic area . . . established or modified by a Bell operating company after [enactment of the 1996 Act] and approved by the Commission").

The power to modify LATA boundaries must be weighed against the prohibition on forbearing from applying Section 271 and the specific enumeration of "incidental interLATA services" that may be provided prior to Section 271 approval. Considered in this context, the FCC may only modify LATAs to address narrowly defined problems created by LATA boundaries and that do not in any way affect interLATA competition. Obvious examples are LATA adjustments to permit expanded local calling service ("ELCS") arrangements. LATA boundary adjustments for ELCS are intended to allow a community that straddles a LATA boundary to avoid the extra expense of making toll calls to other locations within the immediate community. Because of the relatively routine, non-controversial nature of ELCS requests, the MFJ Court established a streamlined process for reviewing them. The MFJ court and the FCC have considered the following criteria when reviewing requests for LATA boundary changes to provide ELCS: (1) the number of customers or access lines involved, (2) whether there is a sufficiently strong community of interest between the exchanges to justify granting a waiver of the Decree to permit local calling, (3) whether the competitive effects of permitting ELCS are more than minimal. The MFJ Court and (since passage of the 1996 Act) the Commission have only permitted ELCS LATA modifications for the purposes of BOC provision of flat-rated local service.[37]

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[37] The FCC has held that a BOC has established a *prima facie* case for LATA modification if

The Commission should only make modifications to LATA boundaries in situations such as ELCS requests, where no impact on competition in interLATA services is possible. MFJ precedent, FCC LATA modification decisions and the terms and structure of Section 271 mandate this result. In no case should the Commission modify LATA boundaries for the purpose of allowing a BOC to provide long distance data services in competition with just that class of competitors who are most vulnerable to BOC abuse of their local monopoly: advanced data service providers that must rely on the BOCs for essential inputs of production. Furthermore, every time the FCC relieves the BOC, from some part of the interLATA restriction, it reduces the BOCs' incentive to meet the requirements of the 271 competitive checklist. The FCC should therefore abandon its proposal to use LATA adjustments broadly to encourage access to advanced services.

VI. CONCLUSION

For the reasons explained herein, the Commission should abandon its proposal to allow incumbent LECs to provide advanced services via a separate affiliate. Rather, the Commission should

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"the ELCS petition: (1) has been approved by the state commission; (2) proposes only traditional local service (i.e., flat rate, non-optional ELCS); (3) indicates that the state commission found a sufficient community of interest to warrant such service; (4) documents this community of interest through such evidence as poll results, usage data, and descriptions of the communities involved, and (5) involves a limited number of customers or access lines. See Petitions for Limited Modification of LATA Boundaries to Provide Expanded Local Calling Service (ELCS) at Various Locations, *Memorandum Opinion and Order*, 12 FCC Rcd 10646, ¶ 24 (1997).

focus its attention on removing barriers to competitive entry into the advanced services market. Most importantly, the Commission should revise its collocation rules to improve the cost of collocation, improve ILEC provisioning performance, and require more efficient use of central office space. The FCC should also abandon its proposal to rely on interLATA relief as a means of encouraging access to advanced services.

Respectfully submitted,

Brian Conboy
Thomas Jones
WILLKIE FARR & GALLAGHER
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000

ATTORNEYS FOR TIME WARNER TELECOM

October 16, 1998

APPENDIX

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Deployment of Wireline	)	CC Docket No. 98-147
Services Offering Advanced	)	
Telecommunications Capability	)	

REPLY DECLARATION OF LELAND L. JOHNSON, Ph.D.

I, Leland L. Johnson, declare the following:

I am a consultant in telecommunications economics residing in Woodland Hills, California. I previously submitted a Declaration in support of the Comments of Time Warner Telecom filed September 25, 1998. My resume, attached to my Declaration, describes my professional experience and other qualifications.

My purpose is to discuss one topic of particular interest: the recommendation of some commenters that the ILEC be required to share ownership of any advanced services affiliate with outsiders. Doing so, they argue, would help to ensure a greater degree of independence from the ILEC. Especially, this outcome, presumably, would weaken the incentive and the opportunity for the ILEC to engage in anticompetitive behavior.

I conclude that shared ownership generally would help. However, outcomes depend on particular circumstances including the possibility of tacit cooperation between inside and outside owners that would blunt otherwise favorable effects.

MANDATORY OUTSIDE OWNERSHIP

Some commenters recommend that if the separate affiliate approach is adopted a substantial percentage of ownership should be held by outsiders. For example, The Competitive Telecommunications Association concludes that "[w]ith substantial independent ownership, an affiliate is much more likely to operate in its own independent best interests, rather than simply as an extension of the ILEC."[1] AT&T urges that "at minimum, to ensure that ILEC advanced services affiliates 'function just like any other competitive LEC', the Commission should mandate some meaningful quantum of outside ownership of those entities in order for them to qualify for treatment as non-ILEC's.[2] HAI Consulting Inc. notes that with outside participation "[p]lacing the fiduciary duty to promote the interests of all shareholders on the officers of the subsidiary may help in preventing some forms of egregious anticompetitive behavior on the part of the subsidiary."[3] At the same time, AT&T emphasizes that "even when an ILEC retains only a minority interest in an affiliate, the ILEC

[1]The Competitive Telecommunication Association at 22.

[2]AT&T at 21.

[3]HAI Consulting, Inc. at 50; appended to The Association for Local Telecommunications Services.

nevertheless will have both the incentive and the opportunity to subsidize its affiliate's operations or engage in other forms of discrimination."[4]

These statements raise several key questions: what conditions affect the degree to which outside ownership would reduce the threat of anticompetitive behavior? Does the percentage of outside ownership make a difference? Are some forms of potential anticompetitive behavior more affected by pressures of outside ownership than others? In response, I focus on four illustrative strategies involving (a) cross-subsidization, (b) discriminatory access to ILEC essential facilities, (c) overpriced, but non-discriminatory, access to essential facilities, and (d) tacit cooperation between inside and outside owners.

Cross-Subsidization

As described in my Declaration, the threat exists that the ILEC will shift to itself costs from the affiliate with the resulting subsidy to the affiliate enabling it to lower retail prices. Being advantaged over its competitors, the affiliate might succeed in dominating the retail market for advanced services.

At first blush, one might conclude that participation by outside owners would not mitigate this threat. Because the affiliate's relatively low retail prices would be compensated by the subsidy from the ILEC, its profits would not necessarily be lower than in the absence of cross-subsidy. If so, outside owners could not be counted upon to forestall or overturn the ILEC's strategy.

[4]AT&T at 21.

Another consideration intrudes, however: while the ILEC would bear the full cost burden of the subsidy, it would be forced to share the fruits of its affiliate's success with outsiders. Whether the ILEC would thereby be deterred from pursuing anticompetitive cost shifting would depend on the cost burden of the subsidy and the percentage of ownership held by outsiders.

In the extreme case, suppose that the ILEC could pass on to its ratepayers the full amount, dollar-for-dollar, of the costs shifted from the affiliate to itself. Since the ILEC's own shareholders would be fully shielded from any ill effects, the subsidy paid by the ILEC (actually its ratepayers) could be regarded as "free." With the ILEC facing no burden in granting the subsidy, the fact that it must share a portion of longer term excess profits with outsiders would not affect its strategy -- a half a loaf being better than none. The presence of outside ownership would do nothing to reduce the threat of cross-subsidy.

At the same time, this extreme case is plausible only in a world of "automatic" cost-plus rate-of-return regulation. As described in my Declaration, the Commission and the majority of states have moved to price cap regimes. Although by no means perfect tools for protecting ratepayers from anticompetitive cost shifts, price caps generally make more difficult the shifting of costs to ratepayers in comparison with rate-of-return regulation. While some cost shifting to ratepayers must be expected in response to the imperfections of price cap regimes, the pass-through is generally less than dollar-for-dollar. Consequently, the subsidy would impose a cost on the ILEC's own shareholders equal to the shortfall in the pass-through to ratepayers, thus dampening the threat of cross-subsidy. More generally, the threat declines as (a) the burden of the subsidy to the ILEC increases, and (b) the percentage of affiliate ownership held by outsiders increases.

As an important qualification, we must bear in mind that if, somehow, arrangements could be made for outside owners to share the costs of the subsidy with the ILEC in proportion to their share of gains, both could benefit. If outsiders hold X percentage of affiliate ownership and pay X percent of the cost otherwise borne by the ILEC, the ILEC would have the same incentives as in the absence of outside ownership. The overall gains to the affiliate would be greater (assuming that the strategy works) with benefits to both the ILEC and outside owners commensurately expanding. In effect, outside owners would become partners with the ILEC to jointly maximize gains.

Implementing such a scheme might seem an impossible task, however. Computing even rough estimates of the subsidy costs and coming to agreement on how they should be split would trigger unending difficulty including vulnerability to regulatory and antitrust action. At the same time, with each party reacting to the behavior of others, rather than through explicit overtures and agreements, outcomes could become colored by at least rudimentary cooperative behavior. In such cases, the deterrent potential of outside ownership on anticompetitive conduct would be attenuated.

Discriminatory Access to ILEC Essential Facilities

Since much of this proceeding centers around the need to ensure nondiscriminatory access to the ILEC's goods, services, facilities, and information, the obvious question arises about the conditions under which partial outside ownership of the ILEC affiliate would help to achieve that goal. The answer is much the same as described for the threat of cross-subsidization. The ILEC incurs a cost in discriminating in favor of its affiliate, reflecting the net revenues lost from sales not made to competitors as a consequence. Since the benefits of the discrimination to the affiliate must be shared with outside owners, as before, the ILEC's incentives for pursuing this strategy would be reduced. As with cross-subsidy, the ILEC's incentives are weakened (a) the greater is the cost burden it faces in pursuing the strategy, and (b) the larger is the percentage of affiliate ownership held by outsiders. Possibilities of cooperative behavior, attenuating the favorable effects of outside ownership, remain relevant.

Excessive, but Nondiscriminatory, Pricing for ILEC Essential Facilities

Some commenters emphasize the problem posed by ILEC pricing that, although nondiscriminatory, far exceeds cost. While a wholly owned affiliate presumably is indifferent to prices charged by the ILEC (a pocket-to-pocket transfer) competitors would be harmed. As The Association for Local Telecommunications describes UNE procurements, "to the extent that charging its own affiliate unreasonably high prices helps justify applying the same rates to unaffiliated providers (which it clearly should not), the incumbent has yet an additional incentive to make UNEs as expensive as possible.[5] Difficulties in the resale market are similarly described by AT&T:

> [B]oth the monies that an affiliate pays an ILEC for resold services and the funds that the affiliate takes in by selling its own services at retail flow to the same bottom line: that of the ILEC or its parent company. A wholly-owned affiliate will be indifferent to the price it pays for resold services, as it need not earn enough on those services to in fact show a profit because the ILEC's true

[5]The Association for Local Telecommunications at 21-22.

"margin" on advanced services will include both its profit on resold services plus any retail margin earned by its affiliate.[6]

Inclusion of outside ownership would enhance the affiliate's sensitivity to its own bottom line. Attempts by the ILEC to increase its profits by hiking prices to its competitors and its affiliate alike can be expected to encounter resistance from outside owners. This would be especially true if outside owners had positions of high level decisionmaking within the affiliate -- for example, in accordance with AT&T's recommendation that "the Commission should require that the affiliate's outside owners be guaranteed representation on the affiliate's board, and that major corporate decisions be approved by at least a majority of outside board members."[7] Ownership interests so represented would contribute to downward pressure on the ILEC's prices for essential facilities.

Combining Strategies: An Illustration of Tacit Cooperation

Consider a scenario in which the ILEC devises a strategy to set high nondiscriminatory prices for UNEs, with both the affiliate and its competitors potentially suffering large profit reductions. Anticipating resistance from the affiliate's outside owners, the ILEC searches for a way under which these owners could (at least roughly) be compensated. The solution lies in the fact that the ILEC stands to earn large profits from the overpriced UNEs. Using an appropriate portion of these profits in ways that benefit the affiliate may be enough to assuage the concerns of outside owners. This task could be

[6] AT&T at 29.

[7] Id. at 21.

accomplished either by enhanced discriminatory access to ILEC facilities or by cross-subsidization. The cost imposed on the ILEC by either of these two moves would be offset by the profits it earns on overpriced UNEs.

Two aspects of this illustration are notable. First, neither outside nor inside owners need be aware of any anticompetitive behavior on anyone's part. Outside owners might be disturbed that prices for essential facilities are high, but they also observe that the affiliate is nonetheless doing very well in the marketplace. Although its rivals are handicapped by discriminatory access to the ILEC's facilities, this process works in subtle ways hard or impossible to prove (as discussed in my Declaration). It is easy (i.e., comfortable) for owners to be persuaded that no discrimination is taking place and that the affiliate's impressive performance reflects the workings of full and fair competition.

Second, tacit cooperation is probably easier to achieve, ironically, if the interests of outside owners are powerfully concentrated on the affiliate's board of directors along the lines recommended, for example, by AT&T. Interactions within small groups of influential people can facilitate the acceptance and subsequent dissemination of views to the larger groups they represent that the affiliate is (a) acting independently of the ILEC in serving its own interests, (b) dealing with the ILEC in a wholly open manner, and (c) competing on the proverbial level playing field.

CONCLUDING REMARKS

If the Commission concludes that the separate affiliate approach is worth further investigation, it should evaluate the merits of mandating shared ownership. Inclusion of outside ownership may weaken the incentives of the ILEC to engage in anticompetitive cross-subsidization and discriminatory access to its essential facilities, depending in part on the percentage split in ownership. This approach may also bring downward pressure on prices for ILEC essential facilities as a consequence of the affiliate's greater independence in pursuing actions most beneficial to itself.

At the same time, the Commission must be alert to possibilities of outside ownership interests being coopted by the ILEC. My brief comments suggest that the more powerfully are outside owners represented on the affiliate's board of directors, the stronger are the prospects for tacit cooperative behavior.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed on October 13, 1998

Leland L. Johnson